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The Sale of Insurance by National Banks Historical Highlights and Recent Developments

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In *Barnett Bank of Marion County, N.A. v. Nelson*, 116 S.Ct. 1103 (1996), the Supreme Court held that a federal law authorizing the sale of insurance by national banks located and doing business in small towns preempted a Florida statute prohibiting such sales. In the year that has followed, *Barnett* has become the most discussed and debated development in its field and has engendered as much dispute as it attempted to settle.

This Article, which is intended to be representative rather than exhaustive[(1)]

, discusses notable judicial, legislative and regulatory activities in this area. Part I places *Barnett* in historical perspective by summarizing significant court decisions culminating therein. Part II describes selected post-*Barnett* developments, including recent activities of the National Association of Insurance Commissioners ("NAIC"), the Office of the Comptroller of the Currency ("OCC") and Congress. Part III concludes by previewing some of the challenges facing the insurance and banking industries as each learns to function in the post-*Barnett* era.

Significant Court Decisions Culminating in Barnett

Although the battle over the right of national banks to sell insurance is decades old,[(2)] the most significant developments have occurred within the past four years. In addition to *Barnett*, recent influential cases include *Independent Insurance Agents of America v. Ludwig*, 997 F.2d 958 (D.C. Cir. 1993) and *NationsBank of North Carolina v. VALIC*, 513 U.S. 251 (1995). Each of *Ludwig, VALIC* and *Barnett* is significant in its own right; when these cases are viewed collectively, however, their impact on the right of national banks to sell insurance is staggering.

Ludwig. *Ludwig* claims its place in history as the first case to interpret the scope of the geographical restrictions of Section 92 of the National Bank Act. Section 92 provides that a national bank which is "located and doing business" in a place with not more than 5000 inhabitants may act as an insurance agent. In 1986, the Comptroller of the Currency (the "Comptroller") determined that, while Section 92 places geographical restrictions on the location of the bank agency, it does not place geographical restrictions on the solicitation activities of that agency or the location of its insureds.[(3)]

Insurance industry trade associations took issue with this interpretation, and the *Ludwig* litigation resulted.

The only issue before the District of Columbia Court of Appeals in *Ludwig* was whether the Comptroller's interpretation of Section 92 was "permissible". The court noted that the Comptroller has broad administrative powers and is entitled to deference unless his interpretation of Section 92 was clearly contrary to the intent of that statute. Unable to find this contrary congressional intent, the court upheld the Comptroller's interpretation as "permissible".[(4)]

Valic. The Supreme Court's decision in *VALIC* is, like the *Ludwig* decision, significant both for its holding and for the amount of deference granted by the Court to the Comptroller. The *VALIC* litigation arose after the Comptroller authorized a

amount of deference granted by the Court to the Comptroller. The *VALIC* litigation arose after the Comptroller authorized a national bank to act as an agent for the sale of annuities. The Comptroller determined that the sale of annuities is "incidental" to the business of banking, and therefore a permissible activity for national banks under Section 24(Seventh) of the National Bank Act. The Comptroller also determined that a national bank's sale of annuities is not limited by the geographical restrictions of Section 92 because annuities are investments, not insurance.

The Supreme Court upheld the Comptroller's decision, and in doing so rendered two very significant holdings. First, the Court expressly held that the "business of banking" is not limited to the powers enumerated in the National Bank Act. Rather, *the Comptroller has the discretion, within reasonable bounds, to authorize activities beyond those specifically enumerated.* Since annuities are similar to other investment instruments commonly sold by banks, the Court believed that the Comptroller's decision that their sale is "incidental" to the business of banking fell within those reasonable bounds, and therefore was entitled to deference.

The second, and perhaps more significant, holding of the Court arises from the Comptroller's determination that the "place of 5000" limitation of Section 92 does not apply to annuities because annuities are not "insurance". In upholding the Comptroller's classification of annuities as investments rather than insurance, the Court determined that Section 92 *does not require automatic reference to state law in determining what activities do or do not constitute insurance*. The significance of this decision becomes clear when one considers that Section 92 provides the only authority under which national banks may conduct general insurance activities. By classifying annuities as "investments", rather than "insurance", the Comptroller effectively avoided the restraints of Section 92.

Barnett. In *Barnett*, the Supreme Court was faced with a Florida statute which prohibited agents affiliated with financial institutions from selling insurance in Florida, and Section 92 of the National Bank Act, which as discussed above permits national banks to sell insurance through their "place of 5000" branches. The Court first held that, under ordinary preemption rules, federal law (Section 92) governs over conflicting state law. Noting that the grant of bank powers by Congress historically has not been subject to state interference, the Court rejected Florida's attempt to reconcile the two statutes by interpreting Section 92 as authorizing the sale of insurance by banks only if state law so permits.

The Court then considered the effect of the "reverse preemption" provisions of the McCarran-Ferguson Act, which provides that a state law which is enacted for the purpose of regulating the business of insurance preempts conflicting federal law, unless that federal law specifically relates to the business of insurance. The Court determined that Section 92 does, in fact, "specifically relate to the business of insurance" within the meaning of the McCarran-Ferguson Act, thereby rendering the special "reverse preemption" provisions of that Act inapplicable. The *Barnett* holding means that *state insurance laws which "prevent or significantly interfere" with a national bank's insurance activities are preempted by Section 92*.

Selected Post-Barnett Developments

Ludwig, VALIC and *Barnett* have ushered in a new era in which the focus has shifted from *whether* national banks will sell insurance to *how* they will do so and *who* will regulate them. Not surprisingly, the battle over these secondary questions is as heated - and gives every indication that it will be as protracted - as the original fight. Recent responses to these questions by the NAIC, the OCC, Congress and major insurance industry trade associations are summarized briefly below.

NAIC Response. The NAIC addressed these secondary questions quite specifically in a Resolution adopted by it in June, 1996, in which it urged Congress and the Clinton Administration to reaffirm that states are "principally and primarily" responsible for regulation of national bank insurance agency activities.[(5)]

The Resolution also urged state insurance regulators to apply state insurance laws to all bank insurance agency activities to protect consumers to the extent permitted by law. At its 1997 Spring Meeting, the NAIC adopted a new Resolution in which it not only restated the substance of the 1996 Resolution, but also expressed its support of "functional regulation" of the financial services industry for the "protection of the insurance-buying public" and its opposition to federal legislation that would preempt state insurance laws, including those laws "pertaining to redomestication, demutualization, licensing, examination, solvency and unfair trade practices."[(6)]

The NAIC also has given official status to a Special Committee on Bank Sales of Insurance (the "NAIC Special Committee"). That Committee has in turn formed two joint working groups with the OCC, one of which is addressing consumer complaint issues and one of which is coordinating activities of the OCC and the various state regulators. Among

consumer complaint issues and one of which is coordinating activities of the OCC and the various state regulators. Among other activities, the NAIC Special Committee provided comments to the OCC on its advisory letter on insurance and annuity sales activities (discussed below) before that letter was published in final form, and persuaded the OCC to implement some of those comments in the final draft.[(7)]

OCC Response. On October 8, 1996, and in response to *Barnett* and *VALIC*, the OCC issued an Advisory Letter entitled "Guidance to National Banks on Insurance and Annuity Sales Activities".[(8)] The Advisory Letter relegates state insurance laws and regulators to a relatively minor role in regulating bank sales of insurance. Although the Advisory Letter does acknowledge that state insurance laws of general application which do not discriminate against or have a disparate impact on banks generally will not be preempted under the "prevent or significantly interfere" standard set forth in Barnett, it attempts to expand that standard by stating that "a relatively small level of impact on the authority of national banks is sufficient to result in federal preemption of the state law at issue."[(9)]

While the Advisory Letter does not give specific examples of state laws which the OCC believes will be preempted, Julie Williams, Chief Counsel of the OCC, has advised the NAIC Special Committee that she considers laws which limit dual employee arrangements, which require that bank and insurance operations be physically separate, or which require insurance sales to be conducted through a bank subsidiary, to be preempted.[(10)]

Additionally, the OCC has demonstrated, in two recent rulings, its intent to construe Section 92 as broadly as possible. Even before the Supreme Court decided *Barnett*, the OCC made headlines when it authorized Magna Bank of Missouri to continue to own and operate an insurance agency upon its conversion from a state to a national bank, even though some of the agency's thirty-three (33) offices are not located in a "place of 5000" (and therefore are not authorized by Section 92). The OCC authorized Magna Bank to retain the agency based upon a statute that permits the Comptroller, in his discretion, to allow a converting bank to retain "assets" which do not conform to federal requirements.[(11)]

In November, 1996, the OCC issued a much anticipated interpretive letter to First Union Corporation (the "First Union Letter") in which it concluded, in part based upon *Ludwig*, that an insurance agency established by a national bank in a "place of 5000" should be permitted to engage in any solicitation and sales activities that would be permitted for non-bank affiliated agencies.[(12)]

According to the First Union Letter, so long as a bank agency is "bona fide", it and its agents may (1) meet with customers and solicit and sell insurance both within and without the "place of 5000"; (2) mail advertisements and solicitation material, and distribute brochures, leaflets, and other literature, from locations both within and without the "place of 5000"; (3) conduct telemarketing and cybermarketing from locations both within and without the "place of 5000"; and (4) contract with third parties to provide "back office" support. A bank agency is "bona fide" if it manages and pays commissions to its agents from, and maintains its business location (for licensing purposes) and copies of all business records in, the "place of 5000".[(13)]

Congressional Response. Only days after the 105th Congress convened, Representative Leach (R-Iowa), Chairman of the House Committee on Banking and Financial Services, introduced H.R. 10 (the "Financial Services Competitiveness Act of 1997").[(14)]

H.R. 10 would, among other things, (1) codify the *Barnett* standard by providing that state laws which prevent or significantly interfere with national bank insurance activities are preempted; (2) reaffirm (subject to the foregoing) the right of each state to regulate the manner in which national banks may sell insurance within the state, and to some extent the manner in which national banks may sell annuities within the state; and (3) require the OCC and the courts to consider the views of the insurance regulatory authority of the state in which a product is to be provided in determining whether such product is an "annuity" or "insurance". Additionally, Representative Roukema (R-N.J.) has introduced H.R. 268 ("Depository Institution Affiliation and Thrift Charter Conversion Act")[(15)] and Representative Baker (R-La.) has introduced H.R. 669 ("Depository Institution Affiliation Act")[(16)], both of which address insurance underwriting and agency activities of depository institutions, their holding companies and affiliates.

While the initial flurry of legislative initiatives may seem promising to those who believe that legislative intervention is overdue, the lessons of the 104th Congress - which saw several such initiatives fail - are sobering. In June, 1996, Representative Leach was forced to cancel further work on H.R. 2520 (the "Financial Services Competitiveness and Regulatory Relief Act of 1995"), an Act which would have reaffirmed each state's authority to regulate the insurance activities of national banks in that state. One month later, an amendment offered by Representative Solomon (R-N.Y.), which

activities of national banks in that state. One month later, an amendment offered by Representative Solomon (R-N.Y.), which would have reduced funding for the OCC if that agency permitted national banks or their operating subsidiaries to "engage in insurance activities in which national banks are not permitted to engage as of July 16, 1996", was soundly defeated.[(17)] And, although Congress did pass banking legislation as part of an omnibus appropriations bill in late September, 1996, that legislation did not include language which would have required banks conducting insurance agency activities to acquire state licenses.

Insurance Industry Trade Association Response. The American Council of Life Insurance ("ACLI") and the Independent Insurance Agents of America ("IIAA") -- historic foes of bank insurance activities -- more recently have expressed a pragmatic acceptance of those activities as inevitable in the post-*Barnett* era. Abandoning their efforts to exclude banks from the insurance industry altogether, these groups are focusing instead on regulatory and consumer protection issues. In September, 1996, the ACLI Board of Directors revised the ACLI's policy position on banking and insurance and agreed to support insurer/bank affiliations "but only if they are implemented consistent with each of" ten principles; these principles include state insurance department regulation of all entities performing insurance functions (whether as principal, agent or broker) and the implementation of "stringent" consumer safeguards. The ACLI subsequently became concerned that "the avalanche" of state laws proposed to address financial institution insurance activities have been influenced by agent and banking interests, rather than by insurers, and consequently contain provisions unacceptable to insurers.[(18)] Accordingly, in February, 1997, the ACLI adopted and distributed to all state insurance commissioners a policy statement setting forth the ACLI's position on such state laws.[(19)]

While strongly supportive of functional regulation by state insurance departments, the policy statement objects to what the ACLI believes are overly-broad provisions which may inadvertently and adversely affect existing affiliates of insurance companies (such as brokerage firms and finance companies).

The IIAA also reversed its position in a policy statement adopted in January, 1997; that statement provides that the IIAA "supports financial services affiliations with two vital conditions", namely, that "state regulation of insurance must be preserved through absolute functional regulation" and that "adequate consumer safeguards must be adopted".[(20)] More recently, the IIAA provided a "how-to" guide to agents interested in establishing joint ventures with community banks.[(21)]

Characterizing these recent shifts in position as the "open arms" acceptance of national bank insurance activities would be an overstatement. As evidenced by the ACLI's challenge of the OCC's Magna Bank decision,[(22)] and the IIAA's plan to sue the OCC over the First Union Letter if meaningful financial services reform does not occur,[(23)] insurance industry associations continue to monitor and challenge OCC activities which are not clearly contemplated by Barnett and *VALIC*. And, while the OCC and these associations may both acknowledge that, under *Barnett*, state insurance laws must not "prevent or significantly interfere" with national bank insurance activities, they attribute vastly different meanings to those words: model legislation advocated by the IIAA and others features the very types of restrictions which the OCC's Chief Counsel considers to be preempted under the *Barnett* standard.[(24)] In fact, the OCC is reviewing a Rhode Island law based upon that model legislation to determine whether certain of its provisions are preempted under *Barnett*.[(25)]

Conclusion

For better or worse, a new player has entered the insurance industry and all parties concerned must adapt to survive. Insurance companies must learn effective uses of new distribution channels, and insurance agents must learn to turn increased competition into new marketing opportunities. Banks and the OCC must learn how to deal with insurers, agents, consumers and state insurance regulators in an area that may be more challenging than it appeared from the outside. The toughest task may fall to state insurance regulators, who must learn to apply state insurance laws to banks without running afoul of *Barnett* and *VALIC*; already, a new generation of bank-related litigation, challenging a variety of state insurance laws, is taking the time and resources of insurance departments around the nation.[(26)] Finally, consumers -- who arguably have the most to win or lose -- must learn to be a bit more savvy as the insurance industry adjusts to a set of new rules.

1.

[1.] This article addresses the law governing insurance *agent* (as opposed to underwriting) activities of *national* banks only. The laws governing bank holding companies, state banks and other financial institutions differ from those governing national banks and require separate treatment beyond the scope of this article.

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2.

[2.] In the early case of Saxon v. Georgia Association of Independent Agents, 399 F.2d 1010 (5th Cir. 1968), the Fifth Circuit struck down a 1963 OCC ruling authorizing national banks to engage in insurance activities.

3.

[3.] The Comptroller previously had determined that Section 92 permits a national bank with a branch office located in a "place of 5000" to sell insurance through that branch even though its principal office is located in a larger community. 12 C.F.R. 7.7100 (1996).

4.

[4.] The Seventh Circuit reached the same conclusion in NBD Bank, N.A. v. Bennett, 67 F.3d 629 (7th Cir. 1995). The Second Circuit may have the opportunity to address this issue in the near future; a Connecticut bank is suing the Connecticut Department of Insurance over its determination that national bank insurance sales are limited to customers located within the "place of 5000". Shawmut v. Googins, No. 3:94CV146JDA (D. Conn. filed Feb. 1, 1994).

5.

[5.] NAIC Resolution Supporting State Authority to Regulate Bank Insurance Agency Activities (NAIC Compilation 2nd Quarter 1996).

6.

[6.] 1997 NAIC Resolution Supporting State Authority to Regulate Insurance Activities of Financial Institutions (NAIC Compilation 1st Quarter 1997).

7.

[7.] See Letter from Lee Douglass, Chair of NAIC (EX) Special Committee on Bank Sales of Insurance, to Eugene A. Ludwig, Comptroller of the Currency (July 23, 1996) (Attachment One-B to minutes of Sept. 29, 1996 meeting of NAIC (EX) Special Committee on Bank Sales of Insurance) (NAIC Compilation 3rd Quarter 1996).

8.

[8.] O.C.C. Advisory Letter 96-8 (Oct. 8, 1996).

9.

[9.] Id. at n. 7. According to the Advisory Letter, the "threshold" for federal preemption reflects both (1) the Barnett Court's discussion of federal preemption and (2) the cases cited by the Barnett Court, which cases use terms such as "interfere with" "impair", "incapacitate", "hinder", "encroach", "frustrate the purpose", "hamper" and "impair the efficiency" in describing the federal preemption test. The NAIC Special Committee objected to the OCC's expansion of the Barnett standard by reference to pre-Barnett cases in written comments provided to the OCC prior to final publication of the Advisory Letter. See Letter from Lee Douglass, Chair of NAIC (EX) Special Committee on Bank Sales of Insurance, to Eugene A. Ludwig, Comptroller of the Currency (July 23, 1996), supra n. 6.

10.

[10.] Remarks (via teleconference) of Julie Williams, Chief Counsel, Office of the Comptroller of the Currency, at a meeting of the NAIC/OCC Priority States Working Group of the (EX) Special Committee on Bank Sales of Insurance (Sept. 30, 1996) (NAIC Compilation 3rd Quarter 1996).

11.

[11.] Magna Bank of Missouri, O.C.C. Corp. Dec. 95-55 (Nov. 15, 1995). See also O.C.C. Inter. Ltr. 757 (April 1, 1996) (explaining OCC's authority to permit a converting state bank to retain non-conforming assets, including an insurance agency, in response to inquiry by the Conference of State Bank Supervisors). The OCC more recently has permitted a converting bank to retain its non-conforming insurance subsidiaries for a period of two years, during which time it must either bring the insurance operations into conformity with federal law or divest itself of such operations. See Key Bank of Missouri, O.C.C. Corp. Dec. 97-14 (Mar. 4, 1997). The OCC also recently granted conditional approval to a national bank's acquisition of an operating subsidiary which conducts, through subsidiaries of its own, non-conforming insurance operations. See Union Planters National Bank, O.C.C. Cond. App. 233 (Feb. 26, 1997).

12.

[12.] First Union Corporation, O.C.C. Inter. Ltr. 753 (Nov. 4, 1996).

13.

[13.] The OCC also has adopted a new operating subsidiary rule (the "Op-Sub Rule") which, while not expressly enabling national banks to conduct underwriting activities through operating subsidiaries, could be used by the OCC as authority to permit such activities in the future. 12 C.F.R. 5.34 (1996). Comptroller Ludwig told the NAIC Special Committee that the OCC will consider an application by a national bank to underwrite insurance through an operating subsidiary if it receives such an application. Remarks of Eugene A. Ludwig, Comptroller of the Currency, at a meeting of the NAIC (EX) Special Committee on Bank Sales of Insurance (Dec. 16, 1996) (NAIC Compilation 4th Quarter 1996).

14.

[14.] H.R. 10, 105th Cong., 1st Sess. (1997).

15.

[15.] H.R. 268, 105th Cong., 1st Sess. (1997).

16.

[16.] H.R. 669, 105th Cong., 1st Sess. (1997). See also S. 298, a virtually identical bill introduced in the Senate by Senator D'Amato (R-N.Y.).

17.

[17.] 142 Cong. Rec. H7684; H7711 - H7712 (daily ed. July 17, 1996).

18.

[18.] See Letter from Carroll A. Campbell, Jr., President and Chief Executive Officer of the ACLI, to All State Insurance Commissioners (Feb. 25, 1997).

19.

[19.] ACLI Policy Regarding State Rules Dealing With Sales of Insurance Including Annuities by Financial Institutions (Adopted by the ACLI Board of Directors on Feb. 25, 1997). The ACLI also recently distributed to interested members of Congress a "discussion draft" of legislation which would address both agent and underwriting activities by national banks and other financial institutions.

20.

[20.] IIAA Policy on Financial Services Affiliations (adopted by the IIAA on Jan. 11, 1997).

21.

[21.] Armstrong and Buse, *Agency/Bank Joint Venture Considerations* (available from IIAA).

22.

[22.] The American Council of Life Insurance v. Ludwig, No. 97-33 (D.D.C. filed Jan. 7, 1997).

23.

[23.] Telephone conference with Jeff Myers, Director of Public Affairs of IIAA (May 15, 1997). According to Mr. Myers, the IIAA has put on hold its plan to file suit against the OCC in connection with the First Union Letter, pending the results of the financial services reform initiatives pending in Congress. Mr. Myers indicated that the IIAA intends to pursue such a suit if financial services reform satisfactory to the IIAA does not occur. Mr. Myers also stated that the IIAA will consider legal action in connection with the OCC's new Op-Sub Rule if that rule is used to grant insurance underwriting authority to affiliates of national banks. (See supra n. 13).

24.

[24.] In response to Barnett, the National Association of Life Underwriters, the National Association of Professional Insurance Agents and the IIAA developed a model "Financial Institutions Insurance Sales Act", which, among other things, limits dual employee arrangements, requires that bank and insurance operations be physically separate, and requires insurance sales to be conducted through a bank subsidiary. As discussed in note 10, supra, and its accompanying text, the Chief Counsel of the OCC considers such provisions to be preempted by Barnett.

25.

[25.] Notice and Request for Comment regarding Preemption Determination, 62 Fed. Reg. 1950 (1997). In a controversial move, the NAIC has chosen not to respond to the OCC's Request for Comment.

26.

[26.] See, e.g., Pennsylvania Life Assoc., et. al. v. Rishel, et. al., No. 74MD97 (Pa. Commonwealth filed Jan. 23, 1997) (industry trade associations are challenging a decision of the state banking commissioner to grant state banks parity with national banks in the sale of insurance); Texas Bankers Association, et. al v. Bomer, No. A-96-CV-694 (W.D. Tx. filed Oct. 8, 1996) (association is challenging interim rules relating to bank sales of insurance and annuities issued by the Texas Insurance Department in June, 1996); Shawmut v. Googins, No. 3:94CV146JDA (D. Conn. filed Feb. 1, 1994) (bank is challenging determination by Connecticut Insurance Department that national banks may sell insurance only to customers located within the "place of 5000"); First National Bank and BancBoston Insurance v. Ruthardt, No. 96CV12075(PBS) (D. Mass. Dec. 19, 1996) (court orders Massachusetts Insurance Department and national bank to reach an agreement permitting national bank to reapply for a previously-denied agency license; court holds that Massachusetts Insurance Department may not block national bank from selling insurance); James Mitchell & Co., JMC v. Florida Department of Insurance and Treasurer, 679 So. 2d 334 (Fla. App. 1996) (court rejects agency's argument that federal law which permits national banks to sell annuities preempts Florida unfair and deceptive trade practices laws). Additionally, the development of legislation and rules responding to Barnett and VALIC are taxing the resources of the state insurance regulators; as of February 25, 1997, the

rules responding to Barnett and VALIC are taxing the resources of the state insurance regulators; as of February 25, 1997, the ACLI had identified no fewer than twenty-five states with pending or proposed bank-related laws or regulations. See Letter from Carroll A. Campbell, Jr., President and Chief Executive Officer of the ACLI, to All State Insurance Commissioners (Feb. 25, 1997).